United States Court of Appeals

for the Second Circuit

AMICUS BRIEF

75-7203

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

B

P/S

ROBERT ABRAHAMSON and
MARJORIE ABRAHAMSON,

Plaintiffs-Appellants,

vs.

MALCOLM K. FLESCHNER, WILLIAM J. BECKER,
HAROLD B. EHRLICH, LEON POMERANCE, FLESCHNER
BECKER ASSOCIATES, and HARRY GOODKIN &
COMPANY,

Defendants-Appellees.

On Appeal from the United States District Court
for the Southern District of New York.

ANSWERING BRIEF OF *AMICI CURIAE* A.W. JONES
& ASSOCIATES; A.W. JONES COMPANY; AVALON;
EUCLID PARTNERS; GOODNOW, GRAY & CO. AND
JUBILEE

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*Prior to amendment by P.L. 91-547, 91st Cong., 2d Sess., 54 Stat. 789 (1970).

Impact of Decision on Amici

Amici curiae are investment limited partnerships located in this Circuit. The February 25, 1977 decision of the Court herein adversely affects them:

1. The Court held that the activities of the general partners of investment limited partnerships fall within the definition of investment adviser as set forth in the Investment Advisers Act of 1940 (the "Advisers Act"). The holding disregards the essential nature of an investment limited partnership. Also it denies the exclusion from the provisions of the Advisers Act which has been relied on in good faith by *amici*, in some instances for almost three decades, with the knowledge that the point had been investigated carefully and accepted without challenge by the Securities and Exchange Commission (the "SEC").

2. The Court, in a statement unnecessary to its decision and relegated to a footnote, stated (Slip Op. n.16 at 6227) that the general partners were investment advisers to the limited partners,

with the consequences that (a) amici will not be able to continue in business as they have for decades, since the basis of allocation of profits among the partners may be deemed to be unlawful and (b) liabilities for past actions (ones not based on fraud) may conceivably be asserted on a technical basis against the general partners of amici.

Facts Relating to Amici

There are substantive differences between an investment limited partnership and the traditional investment adviser-client relationship which is the concern of the Advisers Act. An investment limited partnership is an entity comprised of one or more general partners and one or more limited partners, all of whom, general and limited, combine their investment funds. Often such partnerships are established by closely related individuals who decide to pursue a common line of business, investing, through the partnership vehicle. The rights and obligations of the respective partners are governed by the partnership agreement and the statutory law of the partnership's state of organization.

Investment limited partnerships are in the nature of joint ventures wherein the general and limited partners

aggregate their investment funds. In many instances a general partner's total investment funds are placed at risk in the partnership. There is, consequently, a community of interest between a general partner and the limited partners because the general partner shares dollar for dollar in the losses of the collective undertaking.

The general partner or partners manage the partnership's activities by investing the partnership assets in accordance with the partnership agreement. The usual method of compensating the general partner for his efforts on behalf of the entire group is to provide in the partnership agreement that he be given a greater proportion of the partnership profits, if any.

The relationship between the general and limited partners of an investment partnership is demonstrably a close, regulated and complex relationship of a relatively permanent nature. Community of interest and the elimination of conflict of interest between a general partner and the limited partners are assured by the sharing of risk. The relationship is much different from the investment adviser-client relationship in which the adviser gets an assured fee for investment advice and does not share in the risk.

Argument

I

A GENERAL PARTNER OF AN INVESTMENT LIMITED PARTNERSHIP IS NOT AN "INVESTMENT ADVISER" WITHIN THE MEANING OF THE ADVISERS ACT.

In enacting the Advisers Act, Congress did not intend the definition of "investment adviser" contained in Section 202(a)(11) to apply to the activities of the general partners of investment limited partnerships. The relationship between the general and limited partners of such partnerships is distinctly different from the relationship which the definition of "investment adviser" and the Advisers Act were directed at, as can be seen from the discussion above of investment limited partnerships.

Amici concur in the persuasive analysis on this point contained in the Petition for Rehearing and Suggestion for Rehearing In Banc filed on behalf of the defendants-appellees. The analysis compels the conclusion that the Court's finding that the general partners were "investment advisers" within the meaning of the Advisers Act was erroneous.

The analysis in defendants-appellees' petition is supported by the conduct of the SEC. After prolonged investigation of this precise issue, and with full knowledge of the pertinent facts, the SEC took no action to require registration of general partners of investment limited partnerships as investment advisers.

Under date of June 15, 1966, the SEC issued an order entitled "Order Directing Private Investigation and Designating Officers To Take Testimony." The order was issued by the SEC in relation to a matter described as "In the Matter of Policies and Practices of Certain Organizations Engaged Primarily in the Business of Investing, Reinvesting or Trading in Securities; and to a Significant Extent using Margin Accounts, Loans, Short-selling, Trading in Options and Writing Options in connection with the Trading of Portfolio Securities" (File No. HO-333). In its order, the SEC stated that among the topics to be investigated was whether "unregistered investment companies or managements may be acting as advisers within the meaning of Section 202(a)(11) of the Investment Advisers Act without registration under Section 203(c) thereof."

Acting under that order, the SEC's staff conducted an exhaustive examination lasting over two years into the affairs of two partnerships which were predecessors of certain *amici* herein. This inquiry included the taking of depositions of general and limited partners and the study and consideration of all relevant documents bearing on the partnerships and their operations. At no time during the course of, or even after conclusion of, the investigation were the partnerships or their

general partners advised that they were "investment advisers" within the meaning of the Advisers Act.

It is respectfully submitted that this can only be construed as a definitive conclusion on the part of the SEC, after due inquiry, that general partners are not "investment advisers" within the meaning of the Advisers Act, and that any further action on the issue by the SEC would require legislation.

II

IN ANY EVENT, THE GENERAL PARTNERS HAVE ONLY ONE CLIENT, THE INVESTMENT LIMITED PARTNERSHIP.

Assuming *arguendo*, that by virtue of his activities as a partner of an investment limited partnership, the general partner is deemed to be an "investment adviser" within the meaning of Section 202(a)(11) of the Advisers Act, it remains critically important to determine the client or clients of such adviser. This determination is vital because it bears on an exemption from the provisions of the Advisers Act and accordingly affects the ability of investment limited partnerships, such as *amici*, to continue in business and conceivably could raise the question of liability for past conduct.

For purposes of the instant case involving defendants-appellees, such determination as to who the clients are is not relevant. Plaintiffs-appellants allege a violation of Section 206, the anti-fraud provisions of the Advisers Act. The threshold question is whether the general partners are "investment advisers" under the Advisers Act. Once this has been answered in the affirmative, the general partners are subject to the anti-fraud provisions of Section 206. It is not relevant whether they are entitled to an exemption. However, the availability of an exemption is of critical concern to amici.

Two provisions of the Advisers Act are relevant to amici. The Advisers Act exempts an "investment adviser" from registration under the Act if the adviser has had less than 15 investment advisory clients during any 12-month period and does not hold himself out generally to the public as an investment adviser (Section 203(b)(3)). In addition, the Advisers Act prohibits an "investment adviser" who is, or should be, registered from entering into or performing any investment advisory contract which provides for compensation to the adviser based on a share of gains or appreciation of client funds, except in very limited situations not here relevant (Section 205(1)).

The Congressional purpose in enacting and amending the Advisers Act leads inevitably to the conclusion that general partners of investment limited partnerships are "investment advisers," if at all, only to one client, the partnership, and are therefore entitled to the Section 203(b)(3) exemption.

Individuals who unite in a partnership to pursue a common goal do so for the purpose of centralizing in one entity their combined assets and objectives. Their intent is to engage jointly in business through the partnership entity. Money and property brought to the partnership become partnership property and property acquired with partnership assets becomes partnership property.* A partnership has an existence and a personality apart from it members.

A general partner's management activities on behalf of the partnership's business are special and restricted to the partnership. He does not undertake to manage or make investment decisions for the accounts of limited partners or the public. His activities are undertaken for the private

*See N.Y. Partnership L. §§12(1), 12(2) (McKinney's 1948).

account of only one entity, the partnership, which entity invests in and acquires, sells and holds securities.

The Advisers Act was intended to subject to regulation those persons who, for compensation, enter into advisory relationships with the investing public. However, Congress exempted from registration under the Advisers Act (but not from the anti-fraud provisions) those advisers whose activities were essentially private in nature.

To state in a footnote that "[t]he general partners . . . were the investment advisers to the limited partners," Slip Op. n.16 at 6227, fails to recognize that activities undertaken for the account and on behalf of a partnership are activities of a private nature which Congress in the Advisers Act did not intend to regulate or otherwise deal with, except as to the fraud aspects. The Court's statement, which goes beyond that necessary for its decision, appears to be based on the thought that it was not appropriate to consider the partnership to be a separate entity, but that the partnership should be "looked through" to its individual participants. Such an approach violates the structure and history of the Advisers Act.

Prior to the Investment Company Amendments Act of 1970 (the "1970 Act"),* the Advisers Act exempted from that Act's registration requirements any investment adviser whose only clients were investment companies (usually referred to as "mutual funds") (Section 203(b)(2)). Congress thus had originally determined that, even though such companies might have hundreds or thousands of beneficial owners, the company should not be "looked through" for purposes of determining whether advisers to it were required to register.

The Senate Report to the 1970 Act noted:

> "The Commission's authority to oversee the activities of investment advisers should not depend (as it now does) on whether they offer their services directly or through the medium of an investment company. The shareholders of investment companies should have the same protections now provided for clients of investment advisers who obtain investment advice on an individual basis." S.Rep. No. 184, 91st Cong., 2d Sess. pp. 44-45 (1970).

Congress thus indicated its position that in certain instances it might be advisable to "look through" an entity. Its legislative response, however, confirms the conclusion that essentially private entities, such as investment limited partnerships, should not be "looked through."

*P.L. 91-547, 91st Cong., 2d Sess., 54 Stat. 789 (1970).

The 1970 Act amended Section 203(b) to deny exemption from registration only to advisers to investment companies <u>registered</u> under the Investment Company Act. By this action, Congress recognized the dichotomy between companies required to <u>register</u> under the Investment Company Act (<u>i.e.</u>, public companies) and ones essentially private in nature which were accorded exemption from registration under the Investment Company Act.* And by this action Congress manifested a clear intent not to "look through" entities whose essentially private nature did not subject them to the Investment Company Act** in determining whether the advisers to such entities would be required to register under the Advisers Act.

<u>Conclusion</u>

This Court's holding that the general partners of an investment limited partnership are "investment advisers" and its statement that they are investment advisers to the limited partners represent views that Congress and the SEC, after due consideration, have refused to take. <u>Amici</u> and other

*Section 3(c)(1) provides an exemption from the registration requirements of the Investment Company Act for a issuer whose outstanding securities are beneficially owned by not more than 100 persons and which is not making a public offering.

**The SEC order referred to in Part I of this brief directed against the predecessors of certain <u>amici</u> herein also stated that an examination of whether such partnerships were "investment companies" within the meaning of the Investment Company Act would be undertaken. The SEC after investigation and consideration did not require such registration on the part of the partnerships.

investment limited partnerships have justifiably relied on the action of Congress and the course of conduct of the SEC as supporting the conclusions expressed in this brief. In view of the potentially grave consequences of this holding and statement to investment limited partnerships, it is respectfully suggested that these issues be left to resolution by Congress, a course which would afford opportunity for informed comment by all interested parties.

The statement of the Court in a footnote that the limited partners were the clients of the general partner-investment advisers has a profound impact on the availability of an exemption from the registration requirements of the Advisers Act and on the continued existence of amici. Moreover, this point was not germane to the holding of the Court. To treat this potentially critical matter in this fashion is inappropriate. Accordingly, it is respectfully suggested that, at a minimum, the decision of the Court be modified so as to assure that the existence and availability of the exemption have not been foreclosed.

New York, New York
March 22, 1977

Respectfully submitted,

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CERTIFICATE OF SERVICE

Service of two copies of the annexed Brief of A.W. Jones & Associates; A.W. Jones Company; Avalon; Euclid Partners; Goodnow, Gray & Co. and Jubilee as Amici Curiae was made upon the following counsel for the parties herein by placing same in the United States mail, postage prepaid this 22nd day of March 1977:

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